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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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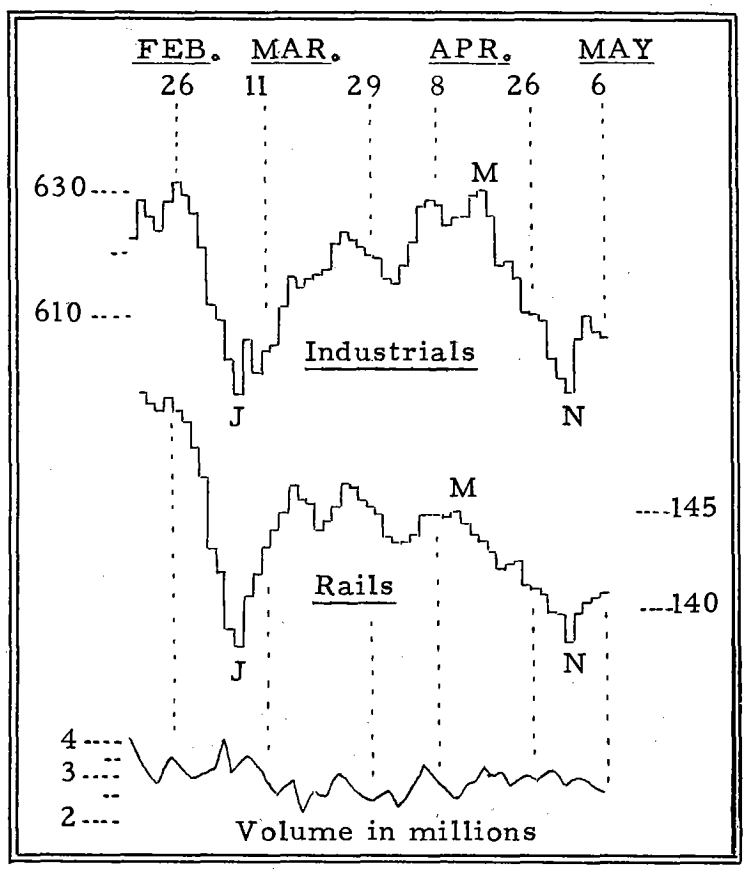
THE MARKET. In a recent Letter (99) I discussed the "evening-up" process which invariably occurs after the market has proceeded for too many days in one direction without a correction. On the rapid retreat from point M (see chart), Rails declined on 11 out of 13 trading days while Industrials declined on 9 out of 10 days. This was one of the longest strings of preponderately down days in recent history. Despite the fact that the two Averages were approaching their bear market lows at J, it was apparent that a rally was overdue.

As it happened, the rally came from just above the bear points. Had the bear points been violated, I believe that a rally would have come regardless, and probably the rally would have taken the Averages back above the bear market lows.

The two day (so far) rally from N was not impressive. Volume contracted on each day while the breadth of the market (ratio of advances and declines) was poor. On the second day of the rally (May 4), for instance, only 574 stocks advanced while 414 declined. Odd-lot ratios, which had been quite cautious up to mid-April, have now moved slowly towards heavier buying balances, and this suggests that the public is tending to consider this more of a buying area (never a bullish sign).

The important one-third to two-thirds correction principle has never shown to better advantage than recently. The rally from J to M corrected 37% of all losses sustained since the January 5 highs. The rally from N has now corrected one-third of the losses suffered on the M-N decline. Because the M-N decline has now been fully corrected, a joint violation of the J points (Industrials 599.10, Rails 138.18) could be more violent than might otherwise have been the case.



Dullness has characterized the market following the rally from N. Regarding dullness Dow wrote, "...the action of the market after dullness depends chiefly upon whether a bull market or a bear market is in progress. In a bull market, dullness is generally followed by advances; in a bear market by declines." Again Dow writes of bear markets, "Prices fall because values are falling, and dullness merely allows the fall in values to get ahead of the fall in prices."

The trend seems to mean little to a goodly number of people, and I still receive inquiries about "what stock to buy."

Perhaps a quote from Rhea (November 10, 1937) will help the perpetual bulls. "Plenty of smart men would not think of shorting stocks in a bull market, no matter how fast the rally had been. They know that to do so would be swimming against the tide; nevertheless, those same men are buying in this bear market after drastic declines, and this procedure is about as logical as shorting a bull market. It is always a good policy to buy into the early stage of a bull market, but the exact reverse is true as concerns bear periods. Buying in bear markets is merely gambling and not very good gambling at that. Why not have cash instead of investments in bear markets? Why insist that one cannot afford to forego investment income when one day's price shrinkage may cancel several years' dividends?"

BEAR MARKET PROCEDURE. The question arises as to when and where shorts should be covered. Personally, I have never been one of those "iron-stomached" individuals who can ride an entire bear market down with a representative list of shorts. I tend to regard shorts as trading commitments and can never resist covering when my shorts drop perhaps 10 to 20%, particularly when such profits come soon after shorting.

At the present time, as the two Averages hover above the bear market lows (J), it might be well to discuss some of the characteristics of panic action. Panics are precipitous drops which may be set off by an unexpected piece of news (i.e. Eisenhower's heart attack, Korea) or by the sudden penetration of important low points. Panics are most likely to occur when the technical position of the market is weak, regardless of whether the primary trend is bullish or bearish. During panics the market seems to lack any sort of organized support with the result that selling becomes chaotic. Fortunately, panics are few and far between.

It is possible (nobody can know, of course) that if the Averages violate the lows at J, a heavy selling wave on a late tape may be set off. During panics stocks drop too far and too fast, and for this reason shorts may be covered during panics to great advantage.

There is always an automatic rebound from panic lows, and this rebound recovers 40 to 60% of the losses sustained during the panic. Hamilton observed, "It is a uniform experience, over the years when such Averages had been kept, that a panic decline is followed by a sharp rally of from 40% to 60% of the movement, and then by an irregular sag ultimately carrying the price to about the old low point."

Many veteran traders will cover shorts during a panic, then switch to the buy side in order to "scalp" the market on the automatic rebound. Although such procedure is not recommended for neophytes, it is not as dangerous as it sounds, providing the new acquisitions are sold immediately after the rebound.

The bottom of a panic can often be identified as follows: a late tape, perhaps lasting all morning or most of the day, will send prices to unexpected lows. Then a period of extreme dullness will ensue, perhaps lasting ten minutes to an hour. Following this the tape will become late on the upside and this usually signals the end of the panic, and the beginning of the recovery.

THREE PSYCHOLOGICAL PHASES Judging by the letters received, there seems to be some confusion about primary legs in a bear market (which are price movements) and the three (psychological) phases. A bear market, by definition, is a series of two or more broad downward swings (primary legs) and at least one secondary (upward) correction. Some bear markets have consisted of the minimum two primary legs, other have had many more. The great 1929-32 bear market was made up of eight distinct primary legs and seven secondary corrections.

On the other hand, all bear markets are subject to three psychological phases. In the

first phase stocks sell minus the "hopes and expectations" which accompanied the previous bull market top. In this phase business remains relatively good, and distribution comes largely from informed sources. The second phase is usually the longest, and here stocks go down in response to obviously deteriorating business conditions and contracting corporate earnings. The second phase is often characterized by severe panics and sudden collapses in individual issues (due to poor earning reports or unexpected bad news). The last phase of a bear market is marked by distress liquidation, and it is in this phase that the "blue-chips" are hit hardest. The reason for this is explained by Hamilton: the final phase has "...driven securities far below their acknowledged worth, for the good reason that the Stock Exchange presented a market for them at some price where the market for other things had disappeared altogether." At the bottom noted Rhea, the prevailing psychology is one of "hopelessness."

In my opinion, we are now well into the first phase of the current bear market. Stocks are beginning to sell minus the "hopes" of the "Soaring Sixties", yet there are still (at this writing) too many "high-flyers" to suggest that the first phase is drawing to a close. The current attitude seems to be that business is still good, and that it is merely leveling off on the proverbial "high plateau".

The first phase will end when it is widely conceded that the boom is over and that the economy is definitely heading down. This could happen in a month or six months; I will discuss it further as we come closer to the event.

MARGINS. In glancing over a chart of the market action since January 5, I was struck by the overall uniformity of the volume picture. Volume has held remarkably level since early January, seeming to fluctuate between about 2 1/2 and 3 million shares daily. One reason that the drop of the last four months has not been more violent and has not brought out more volume is the almost total absence of margin calls. This, of course, has not prevented many issues from losing up to 50% of their listed value; it merely means that the majority of stockholders have chosen to "ride their securities down".

This absence of both margin calls and liquidation pressure (volume) may be encouraging to the bulls -- but it is well to remember that there is another kind of margin call, one that could be exercised if the economy goes into a severe slump. This is a call on a part of the mountain of debt which has been built up during the unprecedented 10 year boom. This credit (or debt) has been the very lifeblood of the boom, but if something should occur which served to shake the confidence of the formerly conservative bankers (they are now the biggest bulls around), there could be a very considerable calling of loans. In my opinion, this would serve as one of the greatest margin calls ever witnessed in a bear market.

THE BAROMETER. Hamilton and Rhea believed the stock market barometer to be the only reliable forecasting tool for the businessman. "Our barometer," wrote Hamilton, "is not rather unique, or almost unique, or virtually unique. There is just one of it, and it cannot be duplicated. It does predict....the condition of business many months ahead, and no other index or combination of indices, can assume to do that."

Because there are many corporate subscribers to these Letters, I have attempted to show that Dow's Theory can be used not only as an aid to the investor but as a businessman's barometer of forthcoming economic events. Remembering the glowing predictions of January 1, 1960, it might also be well to remember that Barron's Business Index on that date recorded a high of 106.7. On the week of the bear signal (March 7) Barron's Business Index stood at 101.4, still relatively near the highs. In the Letter which was mailed one day after the bear signal I suggested that businessmen as well as

investors begin "putting their houses in order". This week Barron's Business Index, after dropping almost continuously, registered 93.2. This means that business activity, as measured by Barron's Index (which is adjusted for seasonal and population growth influences) has fallen 14% since the beginning of the year. It also means that as of now, 61% of the drop in business has come after the bear market confirmation.

CONFIDENCE INDEX (C.I.). The latest (May 9) reading on Barron's C.I. shows a sharp drop to 81.5, another new 1959-60 low. Since the C.I. is the ratio between the Dow-Jones broad list of 40 representative bonds and Barron's 10 highest grade bonds, this new figure of 81.5 means that there has been (and continues to be) a steady movement of money from medium-grade to high-grade bonds. When investors are willing to forego yield in deference to safety, the implications are that confidence is waning. This is merely another manifestation of a continuing bear market. A series of new lows in the C.I. suggests a succession of new lows in the Averages. The time lag, historically, runs about two to four months.

NOTES ON STOCKS. The first signs of impending weakness in private aircraft-maker stocks are appearing. Cessna would be a short at a close of 35. Piper is a short on a 54 closing. Secondary office equipment companies, Smith-Corona and Royal McBee have topped and look very poor. Diamond Alkali is one of the poorer chemicals and is a short at a 49 closing. High-quality Dow should be shorted on an 85 closing. DuPont and Union Carbide both cracked major support in February, 1960, and seem to be drifting for want (so far) of any concerted selling pressure. A break into the 86-87 area would be the first sign of weakness in G.E.

STANDARD & POOR'S INDEX OF LOW-PRICED STOCKS recorded a new 1959-60 low of 62.48 last week; the Index hit its high in April, 1959 at 78.62. This is further proof that speculative enthusiasm is on the wane. As explained in previous Letters, once the "cats-and-dogs" hit their ultimate bull market third phase peak, they usually fall away as quickly as they rose.

NOTICE. I have been writing an article for Barron's, and there is a chance that the piece will be scheduled for next week's issue. The subject will be secondary reactions in bear markets, and I believe that all subscribers should find it of interest.

(Written Monday, May 9th - 2 P.M.)